

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-6034,

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos.

77-6034, 77-6038, 77-6045, 77-6048, 77-6065

In re

WEIS SECURITIES, INC.,
Debtor.

GEORGE D. ALDRICH, et al.,
Appellants,

v.

EDWARD S. REDINGTON, Trustee,
and SECURITIES INVESTOR
PROTECTION CORPORATION,

Appellees.

Appeal from the United States
District Court for the
Southern District of New York

JOINT BRIEF OF APPELLANTS IN REPLY TO
BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION

(Counsel For Appellants
Listed on Last Page of Brief)

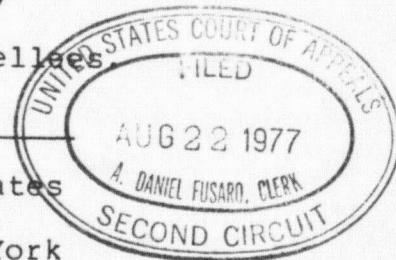


TABLE OF CONTENTS

	<u>Page</u>
TABLE OF AUTHORITIES	ii
INTRODUCTION	1
ARGUMENT	2
I. CLAIMANTS SHOULD BE ALLOWED TO RESCIND EVEN WHEN THE SPECIFIC FUNDS OR SECURITIES AD- VANCED TO WEIS CANNOT BE TRACED	2
II. EQUITABLE CONSIDERATIONS DO NOT SUPPORT THE ELIMINATION OF CLAIMANTS' RIGHT TO RESCIND FOR FRAUD	5
III. CLAIMANTS HAVE A RIGHT TO SHARE IN WEIS' GENERAL ESTATE ON A PARITY WITH BOTH CUS- TOMERS AND OTHER CREDITORS OF WEIS.	8
CONCLUSION	11

TABLE OF AUTHORITIES

<u>Cases:</u>	<u>Page</u>
In re Cartridge Television, Inc., 535 F.2d 1388 (2d Cir. 1976)	4
Cunningham v. Brown, 265 U.S. 1 (1924)	7
Kamberg v. Springfield National Bank, 199 N.E. 339 (Mass. 1935)	3
In re National Discount Corp., 212 F. Supp. 929 (W.D.S.C. 1963)	5
Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206 (1937)	8
SEC v. C. H. Wagner & Co., Inc., 373 F. Supp. 1214 (D. Mass. 1974)	4
SEC v. S. J. Salmon & Co., Inc., 375 F. Supp. 867 (S.D.N.Y. 1974)	3, 10
United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959)	7
 <u>Statutes:</u>	
Bankruptcy Act, Section 57(d), 11 U.S.C. §93(d)	4
Securities Investor Protection Act, 15 U.S.C. §§ 78aaa - 78lll	9
 <u>Treatises:</u>	
3A <u>Collier on Bankruptcy</u> (14th ed. 1975)	4
4A <u>Collier on Bankruptcy</u> (14th ed. 1976)	3
2 Pomeroy, <u>Equity Jurisprudence</u> (5th ed. 1941)	6

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INTRODUCTION

This brief is submitted in reply to the brief
of the Securities and Exchange Commission ("SEC Brief")

filed in the above appeal. Most of the arguments raised in the SEC Brief are answered in the Joint Reply Brief for Appellants dated July 1, 1977 ("Reply Brief"), and no further reply to those arguments is needed. The reply of appellants to those few points in the SEC Brief which merit further reply is set forth below.

ARGUMENT

- I. Claimants Should Be Allowed to Rescind Even When the Specific Funds or Securities Advanced to Weis Cannot Be Traced.

The SEC argues that the remedy of rescission is generally inapplicable in liquidations where the funds or securities with which a creditor has been fraudulently induced to part cannot be identified or traced. That means, according to the SEC, that any claim a subordinated lender may have is really a tort claim for fraud, and such claims are not provable or allowable in liquidation proceedings. (SEC Brief at 15-20) This argument must fail because (1) its conclusion does not follow from its premises, (2) it is unsupported by relevant authority, and (3) it is based on unproven and untrue factual assumptions.

There is apparently no dispute over the proposition that a creditor who has been fraudulently induced to deliver property to a bankrupt debtor and who can trace that property in the debtor's estate is entitled to reclaim such property, even if that means that other creditors will

recover less from the debtor. See, e.g., 4A Collier on Bankruptcy §70.41 (14th ed. 1976). It is also undisputed that the right to reclaim property from a bankrupt debtor applies only when the creditor's property can be traced. Yet it does not follow, and the cases cited in the SEC Brief do not hold, that a defrauded creditor who cannot trace specific property delivered to the debtor therefore must recover nothing from the debtor's estate.

The SEC quotes from Kamberg v. Springfield National Bank, 199 N.E. 339, 341, (Mass. 1935), as follows: "When [the money or property cannot be traced and found], the claim of the person who has been deprived of money or property by fraud . . . ranks no higher than the claims of ordinary creditors." (SEC Brief at 17, fn. 38) The SEC also cites SEC v. S. J. Salmon & Co., Inc., 375 F.Supp. 867, 870-871 (S.D.N.Y. 1974), which states that a person defrauded by a bankrupt can bring a fraud claim as a general creditor to be satisfied out of the bankrupt's general estate. These cases support the position taken by the claimants in this proceeding (the "Claimants"). The District Court's opinion on appeal held that Claimants were not entitled to share in Weis' estate on a parity with general creditors. Claimants contend, and the above cases support their contention, that they are entitled at least to share in Weis' estate as general creditors.

The SEC also argues that the claims of Claimants are "contingent in nature" and that the claims therefore should not be allowed in this proceeding because of Section 57(d) of the Bankruptcy Act, 11 U.S.C. §93(d), citing this Court's opinion in In re Cartridge Television, Inc., 535 F.2d 1388 (2d Cir. 1976). Yet numerous cases have held that fraud claims of the type asserted by Claimants here are provable in bankruptcy on a quasi-contractual basis. See SEC v. C. H. Wagner & Co., Inc., 373 F.Supp. 1214, 1220 (D. Mass. 1974); 3A Collier on Bankruptcy §63.25 at 1894-95 (14th ed. 1975) and the cases compiled there at n. 16. Moreover, as discussed more fully in our previous brief, Section 57(d) is inapplicable to this proceeding since Weis' fraud can be readily proved and the claims of Claimants are not "contingent and unliquidated." (Reply Brief at 6-8) Therefore, Claimants' rescission claims are provable, allowable and entitled to equal treatment with the claims of other creditors of Weis.

Finally, the SEC's argument should be rejected since it is based on unproven and untrue factual assumptions. The SEC assumes, without any citation to the record, that "neither the money nor the securities in question were in the possession or control of Weis at the date that the SIPC trustee was appointed." (SEC Brief at 17) That assumption is wrong — at least part of the money and securi-

ties advanced to Weis by Claimants can be traced to specific bank accounts. At the very least, Claimants are entitled to an opportunity to present evidence that the funds and securities which they advanced to Weis can be identified and traced to funds and securities in Weis' possession as of the date that the trustee was appointed. Therefore, since the SEC's argument is based on unproven and disputed factual allegations, it cannot be used to support summary judgment against Claimants.

II. Equitable Considerations Do Not Support the Elimination of Claimants' Right to Rescind for Fraud.

Another argument advanced by the SEC is that:

"Equitable considerations require that the subordinated loan agreements involved in this case be enforced even if they were procured by fraud." (SEC Brief at 15) The authority cited by the SEC does not support that proposition. To the contrary, principles of equity require that Claimants be permitted to rescind the fraudulently induced subordination agreements, even if other creditors of Weis thereby receive less from the liquidation of Weis' estate.

To support its argument, the SEC quotes from In re National Discount Corp., 212 F. Supp. 929 (W.D.S.C. 1963). Yet that case is clearly distinguishable from this one on its facts. In the National Discount case, the court enforced the subordination provisions contained in subordinated debentures which were issued by the bankrupt company

to four other companies. In reaching its decision, however, the court emphasized the following facts: (1) the four companies seeking to rescind the debentures were related in ownership and management to the bankrupt company; (2) the debentures were issued by the bankrupt company and acquired by the four related companies for the purpose of making the financial condition of the bankrupt company look better than it actually was; and (3) the bankrupt company did not receive full value in exchange for the debentures in these manipulated transactions. The case at bar presents a completely different situation. Claimants are not related to Weis; Claimants did in fact advance to Weis the funds and securities which they are now seeking to recover; and Claimants did not participate in, nor know of, any scheme to fraudulently inflate the financial appearance of Weis.

The only other authority cited by the SEC to support this argument is similarly inapposite. The SEC cites 2 Pomeroy, Equity Jurisprudence §397 (5th ed. 1941), which discusses the meaning of the general principle that "he who comes into equity must come with clean hands." That maxim in no way affects this case since Claimants have "clean hands." The SEC points to nothing in the record to suggest that Claimants are guilty of any wrongdoing, and, indeed, the record fully supports Claimants' contention that they were the innocent victims of a fraud perpetrated by officers

of Weis. See, e.g., Affidavit of Robert E. Slater in Opposition to Motion for Summary Judgment, A372-A374. Therefore, none of the authorities cited by the SEC supports its argument that the subordination of the claims of Claimants is required by equitable considerations.

Moreover, in the context of bankruptcy liquidations, equity normally requires that all unsecured creditors share in the bankrupt's estate on an equal basis, unless a statutory priority provides otherwise. In United States v. Embassy Restaurant, Inc., 359 U.S. 29, 31 (1959), the Supreme Court stated that "the broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate" and that "if one claimant is to be preferred over others, the purpose should be clear from the statute." As discussed more fully in our previous brief, there is no federal statute which provides that Claimants' claims are to be subordinated to the claims of other creditors of Weis. (Reply Brief at 3-6) This case, like Cunningham v. Brown, 265 U.S. 1, 13 (1924), "is a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the [bankruptcy] law." Since Claimants are innocent victims of Weis' fraud just as other creditors of Weis are, principles of equity and fairness require that Claimants be allowed to share in Weis' general estate on a parity with such other creditors.

III. Claimants Have a Right to Share in Weis' General Estate on a Parity with Both Customers and Other Creditors of Weis.

The position taken by the SEC actually supports in large part the legal argument made by Claimants in this appeal. Like Claimants, the SEC disagrees with the District Court's holding that the general creditors of Weis should be accorded priority over Claimants. (SEC Brief at 5, fn. 12) In addition, the SEC agrees with us that if Claimants are able to establish a fraud claim, they should be allowed to share in Weis' general estate along with the claims of Weis' non-customer creditors. (SEC Brief at 20) The reasons underlying the SEC's position are explained more fully in its memorandum submitted below. Citing Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206 (1937), the SEC argued that, with respect to the claims of non-customer creditors, Claimants should be allowed to rescind for fraud and to share in Weis' general estate on a parity with such creditors. However, according to the SEC, Claimants should be subordinated to the claims of customers of Weis because "the specific statutory policy of protecting customers through the financial responsibility requirements overrides the more general policy of providing redress for victims of securities fraud." (Supplemental Designation of Record on Appeal, item 3 at 13)

To support its argument that customer claims deserve priority because of "special policy considerations," the SEC cites a number of cases holding that persons who have been fraudulently induced by a broker-dealer to purchase valueless securities and persons making loans to a broker-dealer do not have "customer claims" under the provisions of the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§78aaa-78lll, establishing insurance protection and a "single and separate fund" for the satisfaction of customer claims. However, these cases are beside the point since the question of whether Claimants have customer claims entitling them to special protection under SIPA is not an issue in this appeal.* Claimants contend merely that the District Court's opinion holding that they are not entitled even to share in Weis' general estate on a parity with other creditors of Weis should be reversed. As discussed more fully in our previous brief, no provision of SIPA gives customer claims priority over the claims of other creditors with respect to the assets contained in the general estate of a bankrupt broker, nor is there any provision in SIPA which abrogates the right of Claimants under the federal securities

* Certain of the Claimants assert that after rescinding their subordination agreements they should be allowed to make customer claims against the Weis estate. However, their claims for customer treatment were not considered in the courts below, and, accordingly, are not in issue on this appeal.

and bankruptcy laws to rescind their subordination agreements. (Reply Brief at 5-6) Indeed, in one of the cases cited by the SEC, SEC v. S. J. Salmon & Co., Inc., 375 F. Supp. 867, 870-71. (S.D.N.Y. 1974), the court stated that fraud claims against a bankrupt broker-dealer could be satisfied out of the bankrupt's general estate. . . .

For all of these reasons, Claimants contend that the purported distinction drawn by the SEC between customers and non-customer creditors is not relevant to this appeal. Upon showing that their subordination agreements with Weis were induced by fraud, Claimants should be allowed to rescind such agreements and share in Weis' general estate on a parity with all other general creditors.*

* The right of customers of Weis to receive up to \$50,000 each from the insurance fund maintained by SIPC, as well as distributions from the "single and separate fund" under SIPA, would not be affected by allowance of Claimants' claims against the general estate of Weis.

CONCLUSION

The order of the District Court should be reversed, and this case should be remanded to the Bankruptcy Court for further proceedings consistent with its opinion of July 15, 1976.

August 19, 1977.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
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	)	
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- - - - -	)	
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	)	
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	)	77-6034
vs	)	77-6038
	)	77-6045
Edward S. Redington, Trustee,	)	77-6048
and Securities Investor	)	77-6065
Protection Corporation,	)	
	)	
Appellees.	)	
- - - - -	)	

CERTIFICATE OF SERVICE

The undersigned hereby certifies that he served the enclosed Joint Brief of Appellants in Reply to Brief of the Securities and Exchange Commission by mailing two copies of the brief by first class mail, postage prepaid, to each of the persons named, at the addresses indicated, on the attached list on August 20, 1977.

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